FILE COPY

Office ... Ct. U.S.
JAMES F. DAVIS, CLERK

IN THE

Supreme Court of the United States

October Term, 1960.

No. 884.

WEST VIRGINIA NORTHERN RAILROAD CO.

COMMISSIONER OF INTERNAL REVENUE.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit.

PETITION FOR REHEARING OF ORDER DENYING PETITION FOR WRIT OF CERTIORARI

INDEX.

	Page
REASONS FOR GRANTING REHEARING AND ISSUING THE WRIT	2
CONCLUSION	11
CERTIFICATE OF COUNSEL	12

CASES CITED.

	Page
Burton-Sutton Oil Company, Inc. v. Commissioner, (1946) 328 U. S. 25	7
Commissioner v. J. S. Abercrombie Co., (CCA-5, 1947) 162 F. (2d) 338	8
Kirby Petroleum Corporation v. Commissioner, (1946) 326 U. S. 599	7
Wilshire Holding Corporation v. Commissioner, (CCA-9, 1958) 262 F. (2d) 51	9

IN THE

Supreme Court of the United States.

OCTOBER TERM, 1960.

No. 884.

WEST VIRGINIA NORTHERN RAILROAD CO.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT.

PETITION FOR REHEARING OF ORDER DENYING PETITION FOR WRIT OF CERTIORARI.

Petitioner prays that this Court grant rehearing of its Order of May 22, 1961, denying the petition for writ of certiorari, — U. S. —, and that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fourth Circuit in the above-entitled case as prayed for in the petition for a writ of certiorari heretofore filed in this matter on April 7, 1961.

REASONS FOR GRANTING REHEARING AND ISSUING THE WRIT.

1. At the time of this Court's order of May 22, 1961 the petitioner could have raised but did not raise an issue with respect to the application by the Court below of the doctrine of substance *versus* form. (A copy of the opinion of the United States Court of Appeals for the Fourth Circuit is printed in the Appendix to the original Petition for Writ of Certiorari. The Memorandum Findings of Fact and Opinion of the Tax Court of the United States is not officially reported but was filed by the Tax Court on October 28, 1959 as T. C. Memo 1959-204. (The unofficial citation is Par. 59,204 P-H Memo. T. C. or 18 TCM 975 (CCH).)

The single issue raised before the Tax Court and appealed to the United States Court of Appeals for the Fourth Circuit involved the deductibility of an amount of 5 cents per freight ton paid by the taxpayer to the Jenkins family ostensibly as part of the rent for locomotives under a lease agreement. The taxpayer argued that the total rental amount, 12½ cents per ton of freight, was deductible as an ordinary and necessary rental expense incurred in carrying on its trade or business of hauling coal. The Commissioner below did not contest the reasonableness of the rate of 12½ cents per ton; he contended that in substance 5 cents of this amount was paid by the taxpayer in satisfaction of an obligation of taxpayer's sole stockholder, Lewis. The Commissioner, therefore, asserted that the 5-cents-per-ton item did not constitute a deductible business expense for the corporation. The true character of the 5-cent-per-ton payments was the issue.

While the Tax Court did not expressly characterize this problem as "substance *versus* form" the Fourth Circuit Court of Appeals did. Granting that the doctrine is applicable, it is the *method* of applying that concept to the facts and the incongruous results reached below that are attacked in this petition for rehearing.

The essence of the petitioner's argument is that, in resolving this case under the doctrine of "substance *versus* form", neither court below took into proper consideration *all* of the surrounding circumstances and, as a result, neither placed a valid interpretation upon all of the facts; incompleteness and misinterpretation are the seeds of the error and unreality is the result.

The appellate court, and the Tax Court as well, appear to have overlooked the significance of the uncontroverted fact that the two options granted by the Jenkins family on December 30, 1950 to the Preston Coal Company, which are the same options assigned on March 19, 1951 to Lewis and later sought to be exercised by him, were from the outset improvident and deficient from the point of view of the Jenkins. These options, negotiated freely before Lewis had even entered the picture, dealt with the three major assets owned by the Jenkins family. One option related to the purchase of the Jenkins family stock in the taxpayer railroad company for $500,000.00 by July 1, 1951. The same option also provided for a 25-year extension of the existing lease of the two Diesel locomotives, (owned by the Jenkins family and the only source of power for the taxpayer) at .7½ cents per freight ton. It also provided that there were to be no adverse changes in the railroad company's balance sheet or capital structure during the option period. A condition of this first option was that the holder of the option must also exercise a second option if it exercised the first. The second option was for the acquisition of some 25,000 acres of coal lands at $50.00 per acre, owned by the Jenkins family, or, alternatively, leasing these properties at a royalty of 10 cents per ton of coal mined and sold with a minimum royalty of $30,000.00 per year.

While the Tax Court refused to recognize any interdependence or relationship between these two options, the substance of the arrangement would appear to be an attempt by the senior Jenkins to dispose of his family's holdings in coal lands, the railroad and the locomotives in one

package transaction. It is not credible that the two options would have been given to two different parties by the Jenkins family and, in fact, exercise of one was a condition precedent to exercise of the other.

No weight has been given to the fact that the option agreements, after they had been obtained by Lewis and he had indicated his intention of exercising them, were in effect repudiated by the Jenkins family as inadequate. Jenkins felt that the terms of the options failed to provide adequate security for his family and he therefore requested certain modifications before exercise of the options by Lewis. It is most important to recognize that it was at the instigation of Jenkins, and not Lewis, that various modifications were proposed in the pre-existing options even though Lewis was at that time under no legal obligation to make any concessions. Jenkins was concerned about the fact that under one option Lewis could immediately acquire the stock of the taxpayer company by a mere down payment, leaving nothing to evidence the unpaid balance except the option itself. He was also concerned about the possibility that the railroad company surplus could be distributed at any time thereafter by Lewis to himself as stockholder, even though the full price of the stock had not been paid to the Jenkins family.

After negotiation, Lewis was willing to make various concessions and modifications in the option agreements which Jenkins requested and this was done by various agreements on September 24, 1951. Notes were given covering the unpaid balance of $450,000.00, the price for the stock and the stock was deposited as collateral, Jenkins was given the right to name two directors to petitioner's Board for a ten-year period, the rental of the 2 Diesel locomotives was to be increased by 5 cents per ton, from 7½ cents to 12½ cents, and the term of the lease for the locomotives was to be reduced from 25 to 15 years, and the Company agreed "not to terminate the said contract during the period of the said lease, nor will the Railroad use any other motive power • • •." No dividends were to be paid by the com-

pany prior to the exercise of the options unless such amounts were credited as payments against the note indebtedness with an exception for a $20,000.00 dividend to be paid immediately to the Jenkins family. The railroad company also was not to increase salaries unless they could be paid from net earnings and no bonds superior to the stock held as collateral on the Lewis note were to be issued. The terms of the coal lands agreement were modified to apply to only 19,660.81 acres and a minimum royalty of $20,000.00.

Finally, and of considerable significance, is the fact that the Jenkins family would *lend Lewis* $90,000.00, $50,000.00 of which was to be the down payment on the stock, $20,000.00 to be an initial payment on the coal property lease, and $20,000.00 for expenses of sale. This amount added to the purchase price of the stock raised Lewis' note indebtedness to the Jenkins family to $540,000.00. The note carried interest at 2 percent per annum and annual payments for 15 years of some $34,000.00 were required after a $20,000.00 down payment 18 months after the date of execution.

During negotiations, Lewis' attorney had contended that the increased rental charge for the locomotives would, in effect, reduce the value of petitioner's stock by syphoning off additional corporate surplus and that it would violate the option requirement that the company's financial condition be the same at settlement as when the option was given. Therefore, he argued, the price of the stock should be reduced correspondingly. The Jenkins family had agreed to this.

As finally written, the lease for the Diesel engines was shortened from 25 to 15 years and the rate of payment therefor was increased from 7½ to 12½ cents per freight ton. The increase of 5 cents per freight ton was to be credited to "payments of the installments due on the [Lewis] note and the balance, if no installments be due, to the payment then due of the minimum royalties on the coal lands."

What fairly may be concluded to be the parties' intent in the light of these circumstances? One conclusion that appears to be immediately obvious is that the senior Jenkins was most desirous of providing something tantamount to a spendthrift arrangement whereby he could insure the steady flow of funds for himself and his four children over a period of 15 years through the efforts of an outsider. This appears to be his primary motivation and purpose. How else can the provision be explained that permitted the 5 cents per ton additional payments under the locomotive lease agreement to be applied first to the note, *but, alternatively, to the royalties on the coal lands?* It seems obvious, also, that the Jenkinses regarded the payments on the *note or royalties as related matter;* while the amounts paid could be deemed royalties, the fact that payments were to be applied *first* to the *note* has a significance which escaped the lower Courts. This factor, read against the indicated willingness of the Jenkins family to agree to a reduction in the stock purchase price should, if given proper weight, lead to the conclusion that basically all that was involved in the 5-cent factor was a device to pass money to the Jenkins family, from the company which had nothing to do with stock *purchase.* If the price of the stock was to be *reduced* below $500,000.00, the original price, then why should the 5 cents per ton be applied against the original $500,000.00 figure? This point has not been considered or answered by the lower Courts.

The fact that the *Jenkins family actually loaned Lewis the $90,000.00, to make this arrangement possible* has not been properly evaluated. This most unusual arrangement is incomprehensible and absurd on its face unless it is considered in perspective. It seems obvious that this transaction cannot be considered in isolation but must be regarded as but one step in an integrated transaction.

Against the background previously developed, its real significance must be that it was an inducement to Lewis to enter into the modified option agreements which had the

effect of reducing the value of the Railroad Company stock he was to receive; the corollary must be that the Jenkins family insisted on the 5-cent-per-ton increase in locomotive rentals motivated, at least partially, by a desire to recoup this amount from the Company. It may be coincidence, but the amount paid on the 5-cents-per-ton factor in the three years before the Court aggregates almost $86,000.00, an amount nearly equal to the $90,000.00 loaned to Lewis.

Coming now to the nub of this discussion, petitioner concludes that, realistically, the 5-cents-per-ton factor was designed and intended to pass to the Jenkins family income of the Railroad Company which they never had surrendered. Agreeing to a reduction in the sale price of the stock in exchange for increased locomotive rental, the 5-cents-per-ton device was a convenient way for the Jenkins family to measure the *reduction* of price for the stock in an otherwise indeterminate and variable situation. This being so, the amounts attributable to the 5-cent factor are not part of the stock purchase price. The Jenkins family had, in effect, retained ownership over this economic income. The fact that the Company had no alternative source of motive power, legally or actually, for the production of income except the Jenkins' locomotives is the unrecognized key to this situation.

This Court, in two related cases, has had occasion to pass upon the question of whether or not a transferor of property can retain a taxable economic interest in net profits produced by the asset leased. Such an issue arose in *Kirby Petroleum Corporation v. Commissioner,* (1946) 326 U. S. 599 and in *Burton-Sutton Oil Company, Inc. v. Commissioner,* (1946) 328 U. S. 25. While both of these cases dealt with mineral leases relating to oil and involved collateral problems such as depletion, they are also authority for the proposition that a taxpayer may reserve a taxable economic interest in property and its attributes despite an ostensible sale, lease or assignment. In *Burton-Sutton Oil Company, Inc. v. Commissioner, supra,* this Court stated:

> "Whether the instrument creating the rights is a lease, a sublease, or an assignment has not been deemed significant from the Federal tax viewpoint in determining whether or not the taxpayer had an economic interest in the oil in place."

The same principle applies here.

The situation here may be analogized to that involved in the case of *Commissioner v. J. S. Abercrombie Co.*, (CCA-5, 1947) 162 F. (2d) 358. This was a case where assignors of certain mineral interests were held taxable upon the income from a retained 1/16th working interest in an oil and gas lease and, conversely, the assignees were held not to have received income consisting of this amount. Analogous "carried interests" are realistically involved here. Despite the verbiage and the form employed, and in light of the changes in the legal relationships of the parties just prior to exercise of the option, the Jenkins family had the purpose of retaining ownership of a portion of the operating profits of the assets (Railroad Company stock and locomotives) they had formerly owned until by application of these funds against the stock price of $500,000.00 the reduced price was reached at the end of the term of the lease.

The provisions they insisted upon for no change in balance sheet obligations, limitations on salaries, restrictions on dividends, the provision for the intervening $20,000.00 dividend and the other related factors discussed above all require this conclusion. Family security and cash flow were the aim. The proviso that the first preference would be to credit the 5-cent locomotive rental payments to the stock of Lewis was simply a recognition of the argument of Lewis' attorney that it worked a diminution in the value of the stock which was accordingly adjusted. While the amount of the reduction was not immediately measurable, the 5-cents-per-ton factor was a convenient way of measuring that amount. Petitioner cannot escape the conclusion

that the substance of all this was that the Jenkins family retained a definite economic interest in the profits of the taxpayer company which was to be measured by the 5-cent factor. That amount belonged to the Jenkins family and not to the company and should not be taxed to the latter.

2. The Courts below could have reached a still different ultimate result when considering the substance of these transactions.

One of the agreements entered into by the Jenkins family and Lewis on September 24, 1951 provided that there was a right "to purchase the two Diesel locomotives and cancel the locomotive contract upon the payment to the then owners of the contract for the locomotives the total sum of $387,500.00." Recall that what is in controversy here is the true nature of the "rental" payments (5 cents per ton of freight hauled) for the use of the locomotives. Also recall that simultaneously the term of the locomotive lease was *reduced* from 25 to 15 years and the amount of rental was *increased* from 7½ cents per ton to 12½ cents per ton. These suggest that in reality the so-called "rental" payments (to the extent of 5 cents per ton) could have been treated as *interest* on deferred installments of the purchase price of the locomotives. Such constructive interest would be deductible by the lessee-purchaser, the taxpayer.

The United States Court of Appeals for the Ninth Circuit has sanctioned such a "substance *versus* form" treatment where it felt required to apportion a part of the ostensible rent to interest on the deferred price under an option to purchase. See *Wilshire Holding Corporation v. Commissioner*, (CCA-9, 1958) 262 F. (2d) 51.

There is a certain persuasiveness to such a substance approach in the present case. It is clearly more logical to attribute a portion of the rental for locomotives to the purchase price of such locomotives under an option to purchase them than it is to attribute such payments to the purchase price of Lewis' stock (discussed in 1. above) as the Courts

below have done. The substance of such an approach supports an opposite result when compared with that reached in the Courts below.

The substance approach in 1. above would treat the questioned portion of the rental payment as taxable income retained by the Jenkins in reduction in the purchase price of the stock; the approach here would have the same net effect, namely, it would allow the deduction of the 5-cent factor as interest if not deemed rent.

3. This broad question and its implications are of major practical importance in the day-to-day administration of the Federal income tax laws. In nearly all instances a taxpayer's troubles with the taxing authorities commence with an audit by an Internal Revenue Agent. These Agents are rarely attorneys and most often have training in accounting. In auditing a taxpayer's return, taxable transactions occurring within the taxable year are examined minutely. Conventionally, some transactions are complex and this is but the logical outgrowth of the complexity of the taxing statutes themselves. In such transactions, as in more routine ones, the Internal Revenue Agent frequently feels called upon to review the form of the transactions as exemplified in various legal documents and papers. At this point, depending upon the ingenuity of the examining Agent, form may or may not be respected and here for the first time a tax case may take a turn in the direction of a "substance *versus* form" approach. This could, of course, take place at a higher administrative level in the Internal Revenue Service but the genesis is usually as described.

What rules guide the Revenue Agent, or anyone else for that matter, in departing from form and launching upon an intellectual exercise designed to ascertain the 'real facts" and the "reality" of the situation? It may be presumed that different minds grappling with the form and the reality of any given set of circumstances can conceivably reach different or indeed conflicting conclusions as to

the realities. The problem becomes more acute where there is absent any clear purpose of tax avoidance. Where the parties in a negotiation have, as a result of the give and take involved in bargaining, agreed upon a certain line of conduct thereafter reflected necessarily in a particular form, what guide lines must be followed to direct this form and arrive at a proper conclusion?

Today, the legal draftsman sees his work more and more frequently ignored. It may be scrutinized with a jaundiced eye and ultimately there may be determined a "substance" clearly not intended by either party. Without adequate guidance and direction, the pursuit of the elusive realities can, and in some circumstances does, produce an absurd result never envisaged. No taxpayer is beyond the threat of this possibility where zeal in tax collection places a premium upon ingenuity and no form, however well drawn, is beyond reach.

If form is to be set at naught in the field of Federal taxation, the process should be surrounded with appropriate safeguards and limitations. The present trend in the administration of the Federal tax laws as exemplified by the present case calls for a better solution to this vexing problem.

CONCLUSION.

For the reasons set forth above and in the petition for writ of certiorari it is respectfully urged that rehearing be granted and that, upo. such rehearing, a writ of certiorari issue to the United States Court of Appeals for the Fourth Circuit.

Respectfully submitted,

ALLEN S. OLMSTED, 2ND,
2301 Packard Building,
Philadelphia 2, Pennsylvania,
Attorney for Petitioner.

FRED R. TANSILL,
824 Connecticut Ave., N. W.,
Washington 6, D. C.,
On the Brief.

Certificate of Counsel.

I hereby certify that the foregoing Petition for Rehearing is presented in good faith and not for delay and is restricted to the grounds specified above, which are other substantial grounds available to petitioner but not previously presented (under Rule 58, 2) which did not come to the attention of petitioner's counsel at the time of the preparation of the original petition for writ of certiorari.

ALLEN S. OLMSTED, 2ND,
2301 Packard Building,
Philadelphia 2, Pennsylvania,
Attorney for Petitioner.